University of Miami Law Review

Volume 34 | Number 1 Article 3

11-1-1979

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Revenue Ruling 78-401: The Retained Control Test of Section 302(b)(1)

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One of the questions remaining unanswered after United States v. Davis *is whether loss of control over corporate acts requiring supermajority stockholder approval constitutes a "meaningful reduction" in a shareholder's proportionate interest so as to qualify for sale or exchange treatment under section 302(b)(1). Recently, in Revenue Ruling 78-401, the Service ruled that such a limited loss of control does not qualify, contrary to two cases holding that it does. The author analyzes the rationale underlying the use of control to test for essential equivalency to a dividend and concludes that the test established in Revenue Ruling 78-401 is correct.*

I. INTRODUCTION

The Internal Revenue Code of 1954[1] sought to resolve the issue of whether a redemption of stock by a corporation was essentially equivalent to a dividend or whether it was in the nature of a capital transaction entitled to capital gains treatment.[2] Judicial confusion had resulted from the failure of prior statutes to adequately define the standards by which such transactions were to be measured.[3] The

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1. I.R.C. §§ 1-9042.

2. United States v. Davis, 397 U.S. 301, 307-09 (1970); *see, e.g.*, Commissioner v. Cordingley, 78 F.2d 118 (1st Cir. 1935) (essential equivalence of distribution to dividend is question of fact); Commissioner v. Quackenbos, 78 F.2d 156 (2d Cir. 1935) (search for valid business purpose and lack of tax avoidance motive); Robinson v. Commissioner, 69 F.2d 972 (5th Cir. 1934).

3. *See* Int. Rev. Code of 1939, ch. 2, § 115(g)(1), 53 Stat. 1 (current version at I.R.C. § 302(b)(1)); Rev. Act of 1926, ch. 27, § 201(g), 44 Stat. 11; Rev. Act of 1924, ch. 234, § 201(f), 43 Stat. 253; Rev. Act of 1921, ch. 136, § 201(d), 42 Stat. 228.

House of Representatives' version of the 1954 Code,[4] codified at sections 302(b)(2) and (3) of the Code,[5] fashioned a set of mechanical, safe harbor rules in an attempt to reduce, if not eliminate, the prevailing confusion. The Senate Finance Committee considered the objective tests too constraining and added section 302(b)(1).[6] Pursuant to section 302(b)(1), a redemption of stock[7] is treated as a sale or exchange if it is not essentially equivalent to a dividend.[8] Although similar to pre-1954 provisions,[9] the new section was designed to avoid past entanglements by limiting the inquiry to whether the transaction could be characterized as a sale or exchange.[10]

Attempting to clarify one aspect of section 302(b(1), the Internal Revenue Service (the Service) issued Revenue Ruling 78-401.[11] In Revenue Ruling 78-401, the Service addressed the issue of whether a reduction in a shareholder's voting interest from ninety percent to sixty percent, pursuant to a redemption, qualified for sale or exchange treatment under section 302(b)(1). The Service held that where a majority shareholder retains more than fifty percent of the voting power of the corporation after a redemption, the trans-

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4. H.R. 8300, 83d Cong., 2d Sess. § 302 (1954).

5. I.R.C. § 302(b)(2)-(3).

6. SENATE COMM. ON FIN., INTERNAL REVENUE CODE OF 1954, S. REP. No. 1622, 83d Cong., 2d Sess. 44 (1954).

7. "[S]tock shall be treated as redeemed by a corporation if the corporation acquires its stock from a shareholder in exchange for property, whether or not the stock so acquired is cancelled, retired, or held as treasury stock." I.R.C. § 317(b).

8. (a) GENERAL RULE.—If a corporation redeems its stock (within the meaning of section 317(b)), and if paragraph (1), (2), (3), or (4) of subsection (b) applies, such redemption shall be treated as a distribution in part or full payment in exchange for the stock.

> (b) REDEMPTION TREATED AS EXCHANGES.—
>
> (1) REDEMPTIONS NOT EQUIVALENT TO DIVIDENDS.—Subsection (a) shall apply if the redemption is not essentially equivalent to a dividend.

Id. § 302(a)-(b)(1).

9. (g) REDEMPTION OF STOCK.—If a corporation cancels or redeems its stock (whether or not such stock was issued as a stock dividend) at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed in redemption or cancellation of the stock, to the extent that it represents a distribution of earnings or profits *accumulated after February 28, 1913*, shall be treated as a taxable dividend.

Int. Rev. Code of 1939, ch. 2, § 115(g)(1), 53 Stat. 1 (current version at I.R.C. § 302(b)(1)) (emphasis added).

10. United States v. Davis, 397 U.S. 301, 311 (1970); S. REP. No. 1622, *supra* note 6, at 234.

11. 1978-2 C.B. 127.

action is essentially equivalent to a dividend.[12] Therefore, dividend treatment, rather than sale or exchange treatment, should apply.[13] This view is supported by many commentators who perceive the major function of section 302(b)(1) as protecting minority shareholders (especially holders of nonvoting, preferred shares) whose redemptions do not meet the strictures of section 302(b)(2) or (3).[14]

The specific issue of whether the loss of two-thirds of the voting power of a corporation but retention of more than fifty percent of the voting power qualifies for section 302(b)(1) treatment has been examined only twice prior to Revenue Ruling 78-401.[15] In both *Wright v. United States* and *Rickey v. United States*, the courts premised their acceptance of the taxpayer's claim to sale or exchange treatment, premising their decisions on the alleged significance of the loss of power by the redeemed shareholders individually to effect those extraordinary corporate acts requiring two-thirds shareholder approval under state law.[16] Both decisions purport to

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12. The Service appears to leave open two situations in which sale or exchange treatment will be given the taxpayer although he does retain 50% of the voting power. If he can show that 50% ownership does not give him control of the day-to-day activities of the corporation or if he can show that a corporate vote requiring a two-thirds majority is imminent, he may escape dividend treatment. *Id.* at 128.

13. Section 302(d) of the Internal Revenue Code provides that "if a corporation redeems its stock . . ., and if subsection (a) of this section does not apply, such redemption shall be treated as a distribution of property to which section 301 applies."

14. *E.g.*, Boyd, *Section 302(b)(1) Redemptions—Recent Developments Indicate They Are Still Alive*, 55 TAXES 491, 496 (1977); *Significant Development, Federal Income Tax—Family Hostility as Mitigating the Constructive Ownership Rules of Section 318 When Applied to the Dividend Equivalency Provision of Section 302(b)(1)*, 55 B.U.L. REV. 667, 679-80 (1975). *See also* Treas. Reg. § 1.302-2(a) (1955); S. REP. No. 1622, *supra* note 6, at 234.

15. Wright v. United States, 482 F.2d 600 (8th Cir. 1973); Rickey v. United States, 427 F. Supp. 484 (W.D. La. 1976). Strictly speaking, *Wright* is not a case arising under § 302(b)(1); it arose out of a reorganization under I.R.C. § 368. In *Wright*, the taxpayer received consideration other than that allowed under § 368. The tax consequences of the receipt of such additional consideration are outlined in I.R.C. § 356 and § 356(a)(2) which provide that "[i]f an exchange . . . has the effect of the distribution of a dividend," such an amount shall be taxed as a dividend to the distributee. The courts, however, have recognized that the dividend provision under § 356(a)(2) should be read in pari materia with the redemption provisions of § 302. *Wright*, 482 F.2d at 605; Hawkinson v. Commissioner, 235 F.2d 747, 751 (2d Cir. 1956) (interpreting relevant provisions of the Int. Rev. Code of 1939); *see* Rev. Rul. 75-83, 1975-1 C.B. 112, 113. Although the validity of this concept as a proposition generally applicable to all redemptions has recently been seriously questioned, Shimberg v. United States, 577 F.2d 283, 287 (5th Cir. 1978), *rev'g*, 415 F. Supp. 832 (M.D. Fla. 1976), *cert. denied*, 99 S. Ct. 1019 (1979), a discussion of *Wright* is relevant because the decision reveals the parameters of § 302(b)(1) as perceived by the courts. For a critical analysis of these two cases, see notes 30-53 and accompanying text *infra*.

16. To amend the articles of incorporation, Connecticut, Hawaii, Louisiana, Maryland and Ohio require a two-thirds vote of shares. MODEL BUS. CORP. ACT ANN. 2d § 59, ¶ 3.03(5) (1971 & Supp. II 1977). In instances where holders of a particular class of shares will be adversely affected, a two-thirds vote (or greater) is required in Alabama, California, Idaho,

comply with the mandates of the landmark decision in this area, *United States v. Davis.*[17]

Davis requires that a redemption must result in a "meaningful reduction" in the proportionate economic interests of a shareholder to qualify for sale or exchange treatment under section 302(b)(1).[18] To infuse some degree of objectivity into the determination of what constitutes a "meaningful reduction in the shareholder's proportionate interest," post-*Davis* decisions have focused on the change of voting stock ownership resulting from the redemption.[19] Except

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Massachusetts, Minnesota, New Jersey, Rhode Island, Tennessee, Vermont and West Virginia. *Id.* Of the states which allow the adoption of amendments by incorporators or directors, Connecticut and Nevada require at least two-thirds of the incorporators or directors to execute the amendment. *Id.* ¶ 3.03(7).

With reference to a voluntary dissolution, a two-thirds vote of all shares entitled to vote thereon is required in Arkansas, Connecticut (or as provided in the certificate of incorporation), Georgia, Louisiana, Maryland, Massachussetts, Minnesota, New York, Ohio, Oklahoma, Tennessee and Wisconsin. *Id.* § 84, ¶ 3.03(4)(f). Alabama, Arizona and Michigan require the approval of two-thirds of the outstanding shares. *Id.* ¶ 3.03(4)(g). Idaho and Utah require the vote of two-thirds of all shares, *Id.* ¶ 3.03(4)(i), and Hawaii requires a three-fourths vote of all stock having voting power. *Id.* ¶ 3.03(4)(j).

With respect to merger or consolidation, a two-thirds vote of approval by shareholders is required in Connecticut, Idaho, Illinois, Kansas, Louisiana, Maryland, Michigan, Minnesota, Missouri, New Hampshire, New York, Ohio, Rhode Island, South Carolina, Vermont and West Virginia. *Id.* § 73, ¶ 3.03(4)(b). Arizona requires the approval by holders of two-thirds in value of all shares. *Id.* Hawaii requires a three-fourths vote. *Id.*

For the sale of assets, approval by two-thirds of the shareholders entitled to vote thereon is required in Colorado, Idaho, Louisiana, Maryland, Massachusetts, Minnesota, Missouri, New York, Ohio and Wisconsin. *Id.* §§ 78, 79 at ¶ 3.03(4)(d). Connecticut, North Carolina, Rhode Island and South Carolina require the consent of two-thirds of the outstanding shares. *Id.* Vermont requires the consent of two-thirds of the outstanding shares of the corporation selling them and the corporation purchasing them, except that if the former is insolvent a majority vote suffices. *Id.* Hawaii requires the approval of three-fourths of the shares entitled to vote. *Id.*

In contrast to the aforementioned states, most states require only a simple majority vote for these transactions. *Id.* §§ 59, 73, 78, 79, 84.

17. 397 U.S. 301 (1970).

18. *Id.* at 313. In *Davis*, the Supreme Court of the United States reached three conclusions regarding the scope of § 302(b)(1): (1) to qualify for treatment as a sale or exchange a redemption must result in a meaningful reduction of the shareholder's interest, *id.*; (2) the attribution rules of I.R.C. § 318 apply, *id.* at 307; and (3) a redemption of a portion of the stock owned by a sole shareholder is *always* essentially equivalent to a dividend, *id.* The Court reached these conclusions by reasoning that a transaction which results in the transfer of property to the shareholder without a reduction in the shareholder's economic interests in the corporation is essentially a dividend. *Id.* at 313.

19. By focusing on the change in voting rights the courts have adopted a control test. The determinative factor is whether the shareholder is in control of the corporation before and after the redemption. "Thus, it seems clear from these recent cases . . . that . . . the courts consider loss of voting control to be the determinative factor . . . ." Randall, *Recent Interpretations of the "Meaningful Reduction" Test of I.R.C. Section 302(b)(1)*, B.Y.U. L. REV. 253, 263 (1977). Accordingly, "[m]any post-*Davis* courts . . . have focused . . . on the shareholder's ability to control future corporate action through voting power as the most

for the *Wright* and *Rickey* decisions, no post-*Davis* authority has afforded sale or exchange treatment to a redemption failing to reduce the redeemed shareholder's interest below fifty percent.[20] The only exceptions to this rule have involved redemptions resulting in a loss of two-thirds majority shareholder status without a loss of simple majority control. Revenue Ruling 78-401 fails to address either of these two exceptions.[21]

This article will focus on the interdependence of the "meaningful reduction" and "control" concepts in the case of redemptions from shareholders owning more than two-thirds of the voting stock prior to the redemption. First, the directly applicable authorities will be examined.[22] Then, the analytical framework employed in cases involving related types of majority shareholder redemptions will be analyzed.[23] Particular attention will center on whether the case law supports the "retained control" test estab-

important factor in determining dividend equivalence." Postlewaite & Finneran, *Section 302(b)(1); The Expanding Minnow*, 64 VA. L. REV. 561, 580 (1978). *See also* Rev. Rul. 75-502, 1975-2 C.B. 111.

The percentage-reduction-in-ownership test has received extensive support in the case law. *See, e.g.*, Shimberg v. United States, 577 F.2d 283, 286-87 (5th Cir. 1978), *rev'g* 415 F. Supp. 832 (M.D. Fla. 1976), *cert. denied*, 99 S. Ct. 1019 (1979); Wright v. United States, 482 F.2d 600 (8th Cir. 1973); Morris v. United States, 441 F. Supp. 76, 79-80 (N.D. Tex. 1977); Rickey v. United States, 427 F. Supp. 484, 492 (W.D. La. 1976); Title Ins. & Trust Co. v. United States, 326 F. Supp. 617, 620-21 (C.D. Cal. 1971), *aff'd*, 484 F.2d 462 (9th Cir. 1973); Benjamin v. Commissioner, 66 T.C. 1084, 1111-12 (1976), *aff'd*, 592 F.2d 1259 (5th Cir. 1979); Furr v. Commissioner, 34 T.C.M. (CCH) 426, 431-32 (1975); Furr v. Commissioner, 34 T.C.M. (CCH) 433, 435-36 (1975); Niedermeyer v. Commissioner, 62 T.C. 280, 287-88 (1974), *aff'd per curiam*, 535 F.2d 500 (9th Cir.), *cert. denied*, 429 U.S. 1000 (1976); Saweison v. Commissioner, 61 T.C. 109, 115 (1973); Fehrs Fin. Co. v. Commissioner, 58 T.C. 174, 185 (1972), *aff'd*, 487 F.2d 184 (8th Cir. 1973), *cert. denied*, 416 U.S. 938 (1974); Stanley F. Grabowski Trust *ex rel.* Grabrowski v. Commissioner, 58 T.C. 650, 655-59 (1972); Miele v. Commissioner, 56 T.C. 556, 567 (1971), *aff'd*, 474 F.2d 1338 (3d Cir.), *cert. denied*, 414 U.S. 826 (1973).

20. In Himmel v. Commissioner, 338 F.2d 815 (2d Cir. 1964), the court identified three economic interests which ownership of shares confers on a shareholder: the right to (1) vote, (2) participate in earnings and profits, and (3) share in corporate assets upon liquidation. *See also* Rev. Rul. 78-401, 1978-2 C.B. 127, 128. Whether these are the economic interests and rights which are significant in a *Davis* analysis is a major topic of debate. *E.g.*, Boyd, *Section 302(b)(1) Redemptions—Recent Developments Indicate They Are Still Alive*, 55 TAXES 491 (1977); Jacobson, *Corporate Distributions: Not Essentially Equivalent to a Dividend; Assignment of Income and Other Problems*, 33 N.Y.U. INST. FED. TAX 1007 (1975); Levin, *Stock Redemption Under I.R.C. Sections 302, 303, and 304*, 80 DICKINSON L. REV. 434 (1976); Postlewaite & Finneran, *supra* note 19; Randall, *supra* note 19; Zinn & Silverman, *Redemptions of Stock Under Section 302(b)(1)*, 32 TAX LAW. 91 (1978); *Significant Development*, *supra* note 14.

21. Wright v. United States, 482 F.2d 600 (8th Cir. 1973); Rickey v. United States, 427 F. Supp. 484 (W.D. La. 1976).

22. *See* notes 25-53 and accompanying text *infra*.

23. *See* notes 54-88 and accompanying text *infra*.

lished in Revenue Ruling 78-401 or the "relinquished control" test of the contrary authorities.[24]

II. Retained Control Versus Relinquished Control: A Study in Contradiction

Revenue Ruling 78-401 is the most recent authority to discuss the tax consequences of redemptions of stock from shareholders initially owning more than two-thirds of the voting stock. The facts of the ruling are surprisingly brief. *X* Corporation had 1,000 shares of voting common stock issued and outstanding, of which *A* owned 90% and *B* owned 10%. *X* Corporation redeemed 750 of *A*'s shares. As a result of the redemption, *A*'s voting interest was reduced to 60%, while *B*'s interest increased to 40%. The laws of state *D*, *X*'s state of incorporation, required approval by two-thirds of the voting shares for such extraordinary corporate acts as merger, liquidation, or sale of substantially all the operating assets.[25] The taxpayer contended that section 302(b)(1) controlled the transaction. Relying on *United States v. Davis,*[26] which holds that only "meaningful reductions in a shareholder's proportionate interest" qualify for sale or exchange treatment under section 302(b)(1), the Service rejected the taxpayer's contention.

In analyzing whether there had been a meaningful reduction in the shareholder's proportionate interest, the Service employed the standards of Revenue Ruling 75-502,[27] *i.e.*, a shareholder's interest consists of three elements: the shareholder's right to (1) vote, and thereby exercise control; (2) participate in earnings; and (3) share in liquidating distributions. Significantly, the Service analyzed only the voting control component of the taxpayer's shareholder interest.[28] Although *A* had surrendered the ability to control those corporate decisions requiring a two-thirds vote, he had retained control of the day-to-day affairs of *X*. In the absence of any indication that extraordinary corporate action was imminent, the retention by *A* of 60% of the voting rights in *X* was deemed to be dispositive of the meaningful reduction issue. Consequently, the Service ruled that the redemption was to be treated as a distribution under the rules of sections 302(d) and 301.[29]

24. *See* notes 15-20 and accompanying text *supra*.
25. 1978-2 C.B. at 127-28.
26. 397 U.S. 301, 313 (1969).
27. 1975-2 C.B. 111.
28. *See* 1978-2 C.B. at 128.
29. *Id.*

The emphasis of the Service in Revenue Ruling 78-401 is clear. Regardless of the supermajority control relinquished by the taxpayer, his retention of simple majority control over the day-to-day activities of *X* was fatal to his claim to sale or exchange treatment. The "retained control" test postulated in Revenue Ruling 78-401 is premised on the theory that one who controls day-to-day activities of a corporation through a simple majority holding of voting stock is in a position to decide whether any corporate distributions will be made and what form they will take. Inherent in such power is the ability to devise means of circumventing the tax impact of dividend distribution through the judicious use of corporate redemptions. Redemptions of control shares should, therefore, be closely scrutinized to determine whether there has been a meaningful reduction in the shareholder's interest.

In reaching its result in Revenue Ruling 78-401, the Service did not discuss two cases which are in apparent conflict with the ruling. The first, *Wright v. United States,*[30] involved the consolidation of two corporations, F & G and Worldwide, Inc., into a new Omni Corporation. Prior to the consolidation, the taxpayer owned 99.2% of F & G's and 56% of Worldwide's voting shares.[31] As a result of the reorganization, the taxpayer held 61.7% of the new corporation, Omni.[32] In addition to the Omni shares, the taxpayer received "boot" in the form of a $102,000 promissory note from Omni.[33]

The only issue before the court was the proper characterization of the boot property. For purposes of determining whether the boot element had "the effect of the distribution of a dividend,"[34] the Commissioner conceded that the redemption rules of section 302(b)

30. 482 F.2d 600 (8th Cir. 1973).

31. Of F & G's 240 total shares, the taxpayer owned 238 shares (99.2%), the taxpayer's wife owned 1 share (.4%), and Mr. John Thurman owned 1 share (.4%). Of Worldwide's 1077 shares outstanding, the taxpayer owned 603 shares (56%), Mr. Dunn owned 323 shares (30%), the taxpayer's mother owned a total of 150 shares (13.9%), and 1 share was owned by Mr. Thurman (.0009%). *Id.* at 602-03.

32. Following the consolidation of F & G and Worldwide, the taxpayer owned 2222 shares of Omni (61.7%), Mr. Dunn owned 1,000 shares (36%), the taxpayer's mother and wife owned a total 355 shares, and Mr. Thurman owned the remaining 23 shares. *Id.*

33. Following the ruling of the District Court that the promissory note constituted "boot" received in a § 368(a)(1)(A) reorganization, the taxpayer conceded that the transaction did constitute a § 368(a)(1)(A) statutory merger or consolidation. *See id.* at 602; note 15 *supra.*

34. I.R.C§ 356(a)(2). For an excellent discussion of the proper tax treatment of boot in a reorganization, see Levin, Adess & McGaffey, *Boot Distributions in Corporate Reorganizations-Determination of Dividend Equivalency,* 30 TAX LAW. 287 (1977).

Serious doubt exists regarding the scope of the *Wright* decision's incorporation of the rules of § 302(b)(1) into § 356(a)(2), in light of Shimberg v. United States, 577 F.2d 283 (5th Cir. 1978), *rev'g* 415 F. Supp. 832 (M.D. Fla. 1976), *cert. denied,* 99 S. Ct. 1019 (1979).

controlled. The court considered, but rejected, the applicability of the "safe-harbor" provisions of sections 302(b)(2) or (3). The court then considered the effect of section 302(b)(1) in the light of *Davis:* "We read . . . *Davis* as holding that the proper inquiry is the percentage change of ownership in the corporation and the attendant overall results due to that change."[35] Having so focused its inquiry, the court proceeded to determine the specific percentage reduction in the shareholder's voting interest. First, the court observed that if F & G and Worldwide had been consolidated without any boot property passing to the shareholder, Mr. Wright would have received 85% of the Omni voting stock. Because boot was present in the reorganization, he received only 61.7% of the Omni voting shares. Consequently, the net percentage change in the taxpayer's voting interest amounted to 23.3%.[36] The only remaining issue was the "meaningfulness" of this reduction. Observing that two-thirds shareholder approval of extraordinary corporate acts was required under state law, the court concluded that the shareholder's loss of such power was meaningful.[37]

In a subsequent decision, *Rickey v. United States*,[38] the District Court for the Western District of Louisiana adopted the *Wright* analysis without qualification. *Rickey* involved a taxpayer's attempt to reduce his 72% voting interest to 49% by means of an initial redemption followed in the succeeding year by various gifts and charitable contributions of his stock. The taxpayer argued that each of the various transactions constituted component elements of an integrated plan. Conversely, the Commissioner insisted that the transactions be taxed as separate and distinct events. Based on a thorough review of the facts, the court held for the taxpayer.

The court fashioned two alternative grounds to support the taxpayer's claim to sale or exchange treatment. First, if viewed as an integrated transaction, the net reduction in the shareholder's voting interest from 72% to 49% satisfied the "safe-harbor" tests of section 302(b)(2).[39] In the alternative, the court held that section

35. 482 F.2d at 609.

36. *See id.* at 609-10.

37. *See id.*

38. 427 F. Supp. 484 (W.D. La. 1976).

39. *Id.* at 490-92. In support of its conclusion, the court observed that a 72% interest was so large that it would be difficult for the corporation to redeem the entire interest upon the shareholder's death; the taxpayer's health was admittedly poor; the taxpayer's control position with respect to other corporations was causing the corporation consolidated return problems; and absent a redemption of some of the taxpayer's shares, the death of the taxpayer might result in passage of that large block of shares to nonoperating persons. These considerations forced the taxpayer to structure the transaction in various steps to achieve the desired

302(b)(1) was applicable to the initial redemption which had resulted in a reduction of the shareholder's control over the total voting power from 72% to 58%. Citing the *Wright* decision, the court concluded that the shareholder's loss of status as a two-thirds majority shareholder altered the economic interests and rights of the shareholders *inter se* so significantly as to constitute a meaningful reduction in the redeemed shareholder's proportionate interest.[40]

A comparison of Revenue Ruling 78-401 with the *Wright* and *Rickey* decisions reveals some startling differences. The focal point in Revenue Ruling 78-401 rests squarely on the element of control *retained* by the redeemed shareholder after the redemption in issue. Despite relinquishment by the shareholder of that bundle of rights inherent in the ownership of two-thirds or more of the voting stock, the retention of more than 50% of the voting power dominates the Service's analysis. Consequently, the ruling adopts a two-step analysis for redemptions from majority shareholders. First, loss of day-to-day control, *i.e.*, ownership of 50% or less of the voting stock, assumes the status of a threshold requirement. Only if this requirement is satisfied, need the inquiry progress to the second, more subjective, issue of the "meaningfulness" of the reduction in question.[41]

In contrast, the *Wright* and *Rickey* decisions focus on the de-

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reduction in Rickey's interest.

> Thus, by applying the mechanical rules of Sec. 302(b)(2) we see that after the completion of the plan, he owned less than 50% of the total combined voting stock, and he owned less than 80% of the stock he had owned prior to the October 1969 redemption . . . . The effect of the overall plan was a substantially disproportionate distribution . . . .

Id. at 492.

40. *Id.* at 492-93.

41. The retained-control test, in effect, begins to look much like the safe harbor tests of § 302(b)(2) when a redemption from a majority shareholder under § 302(b)(1) is involved. As a threshold requirement, § 302(b)(2)(B) mandates that the redeemed shareholder own less than 50% of the total combined voting power after the redemption. I.R.C. § 302(b)(2)(B). Only if this requirement is satisfied does the second issue, ownership of less than 80% of the stock owned prior to the redemption, come into play.

The retained-control test performs a similar function in the § 302(b)(1) area. Only if the majority shareholder retains 50% or less of the voting power after the redemption need the courts examine the more subjective issue of "meaningful reduction." In effect, the retained-control test asks a very simple question: Who has retained the bundle of rights associated with the concept of control: the power to determine furture dividends and redemptions without the approval of minority shareholders?

The courts have perceived the retained-control test as performing double duty. Not only will loss of control satisfy the threshold requirement, but satisfaction of the test (loss of majority status) is itself an indicator of the meaningfulness of the reduction in the redeemed shareholder's interest. For discussion of this analysis, see notes 54-88 and accompanying text *infra*.

gree of control *relinquished* by the redeemed shareholder. Neither opinion discusses the significance of the shareholder's retained control over daily corporate activities.[42] The absolute reduction suffered by Mr. Wright and Mr. Rickey in voting share ownership commands little significance in either decision. Neither court makes any reference to the nature of the control retained by the shareholder. One is left to assume that the result in both decisions would have been the same regardless of the number of voting shares redeemed, so long as the redemption resulted in a loss of two-thirds majority shareholder status. In effect, the *Wright* and *Rickey* decisions equate "control" with its component elements.

Numerous questions remain unanswered after the *Wright* and *Rickey* decisions. First, is the relinquished-control test to be a *per se* test, or merely a case-by-case approach, weighing all the facts and circumstances?[43] If the latter is the proper interpretation, nei-

42. Surprisingly, neither decision discusses the fact that no other authority has ever adopted any definition of control other than simple majority control for purposes of § 302(b)(1). *See* Zinn & Silverman, *supra* note 20, at 96 ("With two exceptions, every court to consider this issue subsequent to *Davis* has made an ultimate finding of dividend equivalency."). *See also* Postlewaite & Finneran, *supra* note 19, at nn. 101, 136-42 and accompanying text (uncertainty about the definition of control in a § 302(b)(1) redemption centers solely around the *Wright* and *Rickey* decisions); Randall, *supra* note 19, at 258-63 (general discussion of control focusing on the predominance of simple majority control in the case law). For a general discussion of the cases discussing control, see notes 44-47 and accompanying text *infra*.

The Tax Court, in Benjamin v. Commissioner, 66 T.C. 1084, 1111 (1976), *aff'd*, 592 F.2d 1259 (5th Cir. 1979), observed that the relevant underlying rights in a § 302(b)(1) inquiry are the right to determine the amount and timing of dividends, redemptions and liquidations; the right to control the board of directors on a day-to-day basis; the power to appoint officers and fix their salaries; and the right to authorize loans. *See also* Stanley F. Grabowski Trust *ex rel.* Grabowski v. Commissioner, 58 T.C. 650, 659 (1972) (control defined as the power to determine dividends and redemptions). Nowhere does *Wright* or *Rickey* discuss these facets of the concept of "control."

43. Neither the *Wright* nor the *Rickey* opinion states whether loss of status as a two-thirds majority shareholder will always produce a meaningful reduction in the shareholder's proportionate interest. The overlay of the actual and constructive ownership rules of I.R.C. § 318 creates numerous unanswered questions. Consider the following hypothetical situations:

(1) Prior to the redemption in issue, *A* owns 80% of the voting stock of *X* Corporation. All 80% is directly owned by *A*. After the redemption, *A* directly owns 60% of *X* and owns an additional 10% of *X's* stock constructively.

(2) Prior to the redemption, *A* owns 65% of the *X* voting stock, directly, and 15%, constructively. After the redemption, *A* directly owns 50% of the *X* voting stock and continues to own an additional 15%, indirectly.

Should the *Wright* analysis apply to the first hypothetical? The courts have rejected any distinction between direct and indirect ownership for purposes of determing control under § 302(b)(1). *Davis*, 397 U.S. at 307. The dissenting opinion of Judge Bright argues that the facts in *Wright* presented such a situation. *Wright*, 482 F.2d at 610 (Bright, J., dissenting). Judge Bright took the majority to task for failing to apply the attribution rules of I.R.C. § 318 to the facts before the court. If the majority had properly done so, Judge Bright noted, the ther court has offered any indication of the factors relevant to such an inquiry.

Second, and more importantly, the relinquished-control test as established in *Wright* and *Rickey* fails to embody both aspects of the *Davis* test. The opinions in both *Rickey* and *Wright* emphasize that the meaningful reduction test fashioned by *Davis* is two-pronged: the redeemed shareholder's voting power must be reduced, and the relationships among the shareholders altered significantly.[44] But the relinquished-control test of the *Wright* and *Rickey* decisions fails to take full account of the latter issue. After determining that the shareholder in each case had suffered a net reduction in his voting interest, each opinion simply states, in a very conclusory fashion, that the loss of status as a two-thirds majority shareholder must represent a meaningful reduction in interest.[45]

Neither opinion discusses the effects of the redemptions on the holders of nonredeemed shares, and both fail to examine

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taxpayer's postredemption interest, augmented by his wife's and mother's shares, would have been 72%. In such an instance, Judge Bright states that even the majority would have denied § 302(b)(1) sale or exchange treatment to the taxpayer. The majority recognized that the attribution rules of § 318 apply to a § 302(b)(1) redemption. *Id.* at 607 n.14. This argument, however, was rejected because the Commissioner failed to raise the issue in a timely manner. *Id.* at 610. Nevertheless, the court failed to indicate what, if any, impact this would have on the analysis and result.

In the second hypothetical, the taxpayer never actually owned the requisite number of shares necessary to command a two-thirds majority shareholder status. Only by attribution does his preredemption interest exceed 66.67% His postredemption holdings, actual and constructive, total 65%. Under *Davis*, no distinction should be drawn between shares actually owned and those constructively owned. Arguably, however, the transaction should not be accorded sale or exchange treatment because the analysis in *Wright* is premised on a taxpayer's ability *individually* to affect the outcome of exraordinary acts, whereas this taxpayer never had such control. If *Wright* establishes a per se test, the transaction should result in sale or exchange treatment because of the strictures of *Davis*. On the other hand, if *Wright* supports a case-by-case analysis, the contrary result could be reached by arguing that the taxpayer never actually had what he claims to have lost. Yet, the analysis in *Wright* offers no guidance to the resolution of this dilemma.

44. *Wright*, 482 F.2d at 608-09; *Rickey*, 427 F. Supp. at 492-93. Courts have repeatedly emphasized the second element of the *Davis* test. *See, e.g.*, Shimberg v. United States, 577 F.2d 283, 286-87, *cert. denied*, 99 S. Ct. 1019 (1979) (denying sale or exchange treatment because relationship with other shareholders had not changed); Morris v. United States, 441 F. Supp. 76, 80 (N.D. Tex. 1977) (relevant question is whether the redemption changed the relative economic interests or rights of the shareholders); Benjamin v. Commissioner, 66 T.C. 1084, 1111 (1976), *aff'd*, 592 F.2d 1259 (5th Cir. 1979) (no change in her relations to the residual shareholders); Furr v. Commissioner, 34 T.C.M. (CCH) 426, 431 (1975) (must change the relative economic interests and rights of ownership).

45. *Wright*, 482 F.2d at 609 ("The redemption here has created a meaningful change in the voting power of the taxpayer under Arkansas law."); *Rickey*, 427 F. Supp. at 492-93 ("Thus under the principles set out in *Davis* and *Wright*, . . . the redemption resulted in a meaningful reduction of Mr. Rickey's ownership interest and significantly altered his economic interests and rights relative to the other shareholders.").

thoroughly the interrelationships among the shareholders. There is no mention of the fact that the minority shareholders possessed no greater control over the corporation after the redemption than they possessed prior to it. For example, such shareholders enjoy no control over the timing or amount of dividends, the adoption of a plan of redemption, the liquidation of the corporation, the appointment of officers and the setting of their salaries, or the authorization of loans.[46] In effect, a majority shareholder's relinquishment of his power to effect, by himself, those corporate acts requiring a two-thirds shareholder approval gives rise only to a veto power in the minority shareholders. No affirmative power is conveyed to the minority; rather, the minority shareholders are possessed only of a power to prevent the majority from implementing certain corporate decisions. Whether this transformation of a majority shareholder's preredemption supermajority power into a post-redemption minority shareholders' veto power constitutes a significant alteration of the shareholder relationships *inter se*, is a question that receives little analytical treatment in the *Wright* or *Rickey* decisions and none in the other relevant authorities.[47]

46. All of these factors have been considered relevant in the determination of what constitutes a meaningful reduction in the shareholder's interest. Benjamin v. Commissioner, 66 T.C. at 1111; *see* Stanley F. Grabowski Trust *ex rel.* Grabowski v. Commissioner, 58 T.C. 650, 659 (1972) (power to declare dividends and redemptions is the relevant inquiry under § 302(b)(1)).

47. It is at this point that the theoretical inadequacies of the relinquished-control test become most apparent. The *Wright* and *Rickey* decisions hold that the relinquishment of a power that the redeemed shareholder had no present intention of exercising, that had no impact on his day-to-day control over corporate activities, and that granted no affirmative power to the minority shareholders is a significant and meaningful reduction in that majority shareholder's proportionate interest. From a subjective standpoint, this raises serious conceptual difficulties. Are we to asume that relinquishment of the power inherent in two-thirds voting ownership is equivalent to the loss of majority ownership? If not, how can one determine the significance of such loss?

One author has argued that the position taken by the courts in *Wright* and *Rickey* is correct:

> To determine whether a redemption results in a shareholder's loss of a significant amount of corporate control, one must consult the origins of corporate power—the articles of incorporation, corporate bylaws, and applicable state law. These sources of corporate power typically provide a supermajority voting requirement for extraordinary corporate transactions, such as amending the articles of incorporation, forcing a merger or a consolidation, or commanding a dissolution or a sale of all the corporate assets. The loss of sufficient corporate control to satisfy these supermajority voting requirements is no less a loss of corporate control or voting power than the loss of corporate control sustained by the shareholder in Revenue Ruling 76-364.

2 J. Corp. L. 568, 579-80 (1977) (footnotes omitted). In Rev. Rul. 76-364, 1976-2 C.B. 91, to which the author analogizes, the Service held that a reduction in voting power from 27% to 22.27% was a meaningful reduction in the shareholder's proportionate interest. The rationale

In contrast, the retained-control test of Revenue Ruling 78-401 fully analyzes both the voting power reduction element as well as the significant alteration of shareholder relationships element of the *Davis* meaningful reduction test. In the ruling, the Service correctly noted that the redeemed shareholder suffered a 30% reduction in his voting interest.[48] This reduction exceeded the percentage reductions in both the *Wright* and *Rickey* decisions.[49] The analysis of the Service did not stop there, however. Instead, the Service focused on the second aspect of the *Davis* test: Were the economic interests and rights of the shareholders significantly altered? The retention by *A*, the redeemed shareholder, of more than 50% of the voting power after the redemption required a negative response to this question. Retention by *A* of exclusive control over the day-to-day operations of the corporation rendered the impact of the

underlying this result was that with 27% of the vote the taxpayer had control of the corporation when voting with only one other stockholder, whereas by reducing his proportion of control to 22.27%, the taxpayer required the vote of at least two other stockholders to control corporate activities.

Similarly, it could be argued that the fact that no affirmative right has been conveyed to the minority shareholders is irrelevant. In Rev. Rul. 75-502, 1975-2 C.B. 111, the Service held that a reduction in control of voting rights from 57% to 50% was meaningful. This redemption did not result in the vesting of any affirmative power in the other single shareholder because the taxpayer could block any proposed action by virtue of his control of 50% of the voting rights. The other shareholder, however, could exercise a similar veto power. The Service held the reduction meaningful because the taxpayer had lost his dominant voting rights. *Id.* at 112.

Nevertheless, most commentators have read the *Wright* and *Rickey* opinions with great skepticism. *E.g.*, Zinn & Silverman, *supra* note 20, at 97 (questioning whether a reduction is meaningful if state law requires supermajority shareholder approval for only a few acts not contemplated at time of redemption and contingent on speculative future events). Moreover, the very arguments postulated in favor of the relinquished-control test demonstrates its myopic approach.

These arguments offer neither authority nor analysis in support of the position that supermajority voting requirements fall within the emerging federal notion of control in a § 302(b)(1) context. It is difficult to conceive of the power of minority shareholders to block certain corporate acts requiring two-thirds shareholder approval as a significant component of control. Furthermore, it is virtually impossible to reconcile this position with case law in the area. Other than *Wright* and *Rickey* there is no support for this proposition. It flies in the face of the analysis proffered in cases which discuss the components of control. The rights mentioned as underlying the concept of control relevant in a § 302(b)(1) inquiry are those which require majority control (*e.g.*, declaration of dividend). *See* note 42 *supra*. Nowhere are acts requiring a supermajority vote mentioned. Even Rev. Ruls. 76-364 and 75-502 involve simple majority control, or its loss.

Moreover, by focusing its inquiry solely on what the majority shareholder has relinquished, the relinquished-control test ignores the issue of the impact of the redemption on the remaining shareholders. Thus, the relinquished-control test fails to analyze fully the effect of the redemption on the interrelationship between the stockholders.

48. 1978-2 C.B. at 128.

49. *See* notes 30-40 and accompanying text *supra*.

redemption on the minority shareholders nugatory. Despite an increased interest in earnings and liquidation proceeds, each minority shareholder posessed no power to effect the distribution of such amounts. In effect, day-to-day control over corporate affairs remained unaltered; with respect to the right to declare dividends or redeem stock, the redeemed majority shareholder still possessed exclusive control.[50]

Finally, the retained control test of Revenue Ruling 78-401 has been the implicit, if not the explicit, foundation of many of the post-*Davis* decisions involving redemptions from majority shareholders.[51] As noted earlier, no other post-*Davis* authority has recognized as meaningful a redemption that fails to reduce a preredemption majority shareholder's interest to 50% or less.[52] In addition, the courts and the Service have repeatedly viewed the "control" concept as the cornerstone of the section 302(b)(1) analytical framework.[53] Outside the *Wright* and *Rickey* decisions, no court has attached any significance to the concept of control other than as defined by simple majority voting stock ownership.

III. Retained Control and Redemptions by Majority Shareholders: An Analysis of the Alternatives

The factual settings typified by Revenue Ruling 78-401 and *Wright* can be described as those in which the redeemed shareholder owns more than two-thirds of the corporate voting power before the redemption, and, although the shareholder's interest falls below that level after the redemption, he still retains simple majority control. This situation, however, represents only a tiny fragment of the broader issue of the proper treatment of corporate redemptions from majority shareholders. Indeed, three additional categories may be identified:

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50. The retained-control test serves two purposes. First, it measures the actual percentage reduction in the redeemed shareholder's voting power. Second, it necessarily calculates the percentage of voting power not owned by the redeemed shareholder. This latter measurement directly relates to the issue of whether the relative rights and interests of the shareholders *inter se* have been significantly altered.

The retained-control test avoids the difficult conceptual problem of subjectively evaluating the meaningfulness of the reduction in the shareholder's number of shares. In place of the subjective inquiry, the retained-control test offers an objective approach: Has the redeemed shareholder retained control over the day-to-day activities of the corporation? An affirmative answer to this inquiry ends the analysis. Only if the response is negative need the court delve into subjective factors.

51. *See, e.g.*, cases cited in note 44 *supra*.

52. *See* note 19 *supra*.

53. *See* notes 19-20 *supra*.

Category I: The redeemed shareholder actually or constructively owns 100% of the voting stock of the corporation before and after the redemption.[54]
Category II: The redeemed shareholder actually or constructively owns less than 100% but more than two-thirds of the voting stock of the corporation both before and after the redemption.[55]
Category III: The redeemed shareholder actually or constructively owns more than 50% but less than two-thirds of the voting stock of the corporation before and after the redemption.[56]

Categorization of redemptions from majority shareholders in this manner facilitates the development of a framework within which to analyze the emerging body of case law and rulings on section 302(b)(1). More importantly, however, this framework reinforces the conclusion that courts focus on the amount of control retained, not the amount of control relinquished, by a shareholder in a redemption. In each decision discussed below, the retention of day-to-day control by the redeemed shareholder is the single, predominant factor. Significantly, in none of these decisions is a redemption involving retention by the redeemed shareholder of more than 50% of the voting power afforded sale or exchange treatment. Thus, despite the factual dissimilarities among the following cases, the retained-control test of Revenue Ruling 78-401 appears to be dispositive of the section 302(b)(1) issue.

A. *Category I: Absolute Control*

The Tax Court's opinion in *Benjamin v. Commissioner*[57] is representative of a Category I redemption pattern. Mrs. Benjamin, the taxpayer, owned all of the class A and class B voting preferred shares of Starmount Corporation. Voting and management control of the corporation were vested exclusively in these two classes of

54. United States v. Davis, 397 U.S. 301 (1970), is an example of this category of redemption. For lack of a more descriptive label, this category will be referred to as "retention of absolute voting control." *See* Benjamin v. Commissioner, 66 T.C. 1084, 1111 (1976), *aff'd,* 592 F.2d 1259 (5th Cir. 1979).

55. This category will be referred to as "retention of dominant voting control." *See, e.g.,* Fehrs Fin. Co. v. Commissioner, 58 T.C. 174, 185 (1972), *aff'd,* 487 F.2d 184 (8th Cir. 1973), *cert. denied,* 416 U.S. 938 (1974); Furr v. Commissioner, 34 T.C.M. (CCH) 426, 431 (1975). The predominant characteristic of this category is the ownership by the taxpayer/shareholder of sufficient voting power, either actually or constructively, to effect any corporate act regardless of the proportion of votes required to approve it.

56. This category consists of redemptions by shareholders who possess only "simple majority voting control." *See, e.g.,* Rev. Rul. 77-218, 1977-1 C.B. 81; Rev. Rul. 75-502, 1975-2 C.B. 111.

57. 66 T.C. 1084 (1976), *aff'd,* 592 F.2d 1259 (5th Cir. 1979).

stock. Starmount redeemed 2,000 of the taxpayer's 4,732 class A shares. The taxpayer claimed that this distribution was not essentially equivalent to a dividend.

The Tax Court unequivocally rejected this argument. Instead, the court found that the changes in net worth and participation in earnings which the taxpayer had experienced were outweighed by her retention of absolute voting control. Arguably, a distribution

> [w]ithout any reduction in control . . . savors of a dividend . . . . Where the redeemed shareholder has sufficient voting power to control the activities of the corporation . . . and where he retains that same degree of control after a redemption distribution, such circumstances are strong indications that the transaction does not come within the confines of section 302(b)(1).[58]

Thus, under the *Benjamin* rationale, a shareholder who retains the same degree of control after the redemption as he had before the redemption will not qualify under section 302(b)(1).[59]

The *Benjamin* decision is unusual in its clarity. Many of the decisions addressing the problem of redemptions from 100% shareholders fail to state clearly whether they are implementing the retained-control or the relinquished-control test.[60] Instead, the courts emphasize either that no reduction in control has

58. 66 T.C. at 1111.

59. *Id.* at 1111-12. The *Benajmin* decision is also noteworthy for its explication of the constituent elements subsumed under the heading "voting control";

> Controlling the activities of a family corporation through voting superiority, or supremacy, is the most significant attribute a shareholder possesses. . . . Such voting control normally carries with it the power to declare dividends and approve a liquidation in addition to other economic advantages such as controlling, through the board of directors, the timing of dividends and redemptions, appointing and fixing the salaries of officers and authorizing loans.

Id. at 1111. Simple majority control possesses all of these attributes.

60. *See, e.g.*, Johnson v. United States, 434 F.2d 340, 344 (8th Cir. 1970) (redemption from sole shareholder always essentially equivalent to a dividend); Greenberg v. Commissioner, 62 T.C. 331, 350-51 (1974) (distribution essentially equivalent to dividend where taxpayer is sole shareholder after redemption), *aff'd mem.*, 526 F.2d 588 (4th Cir. 1975), *cert. denied*, 423 U.S. 1052 (1976); Grey v. Commissioner, 56 T.C. 1032, 1072-73 (1971) (distribution essentially equivalent to dividend if taxpayer exercises substantial control over transaction), *rev'd on other grounds*, 561 F.2d 753 (9th Cir. 1977); Maher v. Commissioner, 55 T.C. 441, 453 (1970) (redemption of sole shareholder essentially equivalent to dividend), *modified*, 469 F.2d 225 (8th Cir. 1972); Estate of Runnels v. Commissioner, 54 T.C. 762, 765-66 (1970) (distribution to constructive 100% owner essentially equivalent to dividend); Estate of Lammerts v. Commissioner, 54 T.C. 420, 444-45 (1970) ("net effect" test inapplicable to 100% shareholder), *aff'd per curiam on other grounds*, 456 F.2d 681 (2d Cir. 1972). *See also* Rev. Rul. 75-174, 1975-1 C.B. 252 (100% before and after) Rev. Rul. 72-57, 1972-1 C.B. 103 (same); Rev. Rul. 71-563, 1971-2 C.B. 175 (same); Rev. Rul. 71-261, 1971-2 C.B. 108 (same); Rev. Rul. 70-496, 1970-2 C.B. 74 (same).

occurred,[61] or that if one has occurred, it did not significantly affect the stockholder's relationship to the corporation.[62]

The analysis in the *Benjamin* decision, resting on the retained control test, represents a welcome clarification of the two-pronged *Davis* test. The court in *Benjamin* never addressed the specific issue of whether a decrease in the absolute number of shares is accompanied by any reduction in voting control. The failure to address this issue can be explained by either of two reasons: First, the court appears to have adopted the no-reduction-in-control test.[63] Alternatively, even if the taxpayer's decrease in shares actually owned satisfied the language of *Davis*, the redemption nevertheless failed to satisfy the threshold requirement of loss of day-to-day control.[64] Either analysis is consistent with the *Davis* test; both analyses are premised on the retained-control test.

B. *Category II: Dominant Voting Control*

In contrast to Category I redemptions, those within Category II do present instances of actual reductions in the taxpayers' voting interests. Despite this distinction, the courts have resorted to an analysis similar to that used in Category I redemptions. Specifically, the retention of control over corporate activities has been dispositive of the taxpayer's claim of sale or exchange treatment under section 302(b)(1).

Category II is represented by a trilogy of Tax Court decisions. The first, *Fehrs Finance Co. v. Commissioner*,[65] involved a section 304(a)(1) redemption.[66] Prior to the taxpayer's sale to the controlled

61. *See* Maher v. Commissioner, 55 T.C. 441, 453 (1970) (no reduction), *modified*, 469 F.2d 225 (8th Cir. 1972).

62. *See* Runnels v. Commissioner, 54 T.C. 762, 766 (1970); Lammerts v. Commissioner, 54 T.C. 420, 444 (1970).

63. 66 T.C. at 1111. It was not necessary to address the issue because the court found that the taxpayer had retained absolute control.

64. The court stated that "[w]hatever changes in net worth and participation in earnings [the taxpayer] experienced . . ., retention of absolute voting control . . . outweighs any other consideration." *Id.*

65. 58 T.C. 174 (1972), *aff'd*, 487 F.2d 184 (8th Cir. 1973), *cert. denied*, 416 U.S. 938 (1974).

66. (a) TREATMENT OF CERTAIN STOCK PURCHASES.—

(1) ACQUISITION BY RELATED CORPORATION (OTHER THAN SUBSIDIARY).—For purposes of sections 302 and 303, if—

(A) one or more persons are in control of each of two corporations, and

(B) in return for property, one of the corporations acquires stock in the other corporation from the person (or persons) so in control, then (unless paragraph (2) applies) such property shall be treated as a distribution in redemption of the stock of the corporation acquiring such stock. In any such case, the stock so acquired shall be treated as having been transferred by the person from whom acquired, acquiring corporation, the taxpayer and his wife owned 98.2% of the shares of the issuing corporation. As a result of the transaction, the taxpayer's voting ownership was reduced to an 88.69% constructive interest. Based upon the elimination of their direct voting stock ownership, coupled with the net percentage reduction in his actual and constructive voting stock interest, the taxpayers sought sale or exchange treatment.

As a preliminary matter, the Tax Court noted that the *Davis* decision eliminated any conceptual differences between actual and constructive ownership for purposes of section 302(b)(1).[67] Therefore, the only issue remaining was the meaningfulness of the 9.51% reduction in the taxpayer's preredemption 98.2% interest. The court resolved this issue by concluding that "[a] reduction . . . from 98.2 percent to 88.69 percent does not deprive such a dominant shareholder of his ability to control the corporate activities; such a reduction does not affect the shareholder's relationship to the corporation in any significant way."[68] There are strong indications in the *Fehrs* opinion that the Tax Court equated control with ownership of a simple majority of the voting stock.[69]

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and as having been received by the corporation acquiring it, as a contribution to the capital of such corporation.

I.R.C. § 304(a)(1).

I.R.C. § 304(b)(1) provides that § 302(b) tests shall be applied with respect to the ownership in the issuing corporation. The amount which may constitute a dividend, however, is limited to the acquiring corporation's earnings and profits. I.R.C. § 304(b)(2)(A). For a discussion of § 304, see Marano, *Section 304: The Shadowy World of Redemptions Through Related Corporations*, 22 TAX L. REV. 161 (1967).

67. 58 T.C. at 187. The Supreme Court of the United States held in *Davis* that the attribution rules of I.R.C. § 318 are applicable to § 302(b)(1). 397 U.S. at 307. Subsequent decisions have interpreted this as meaning that for purposes of determining control under § 302(b)(1), actual and constructive ownership are not to be differentiated. *See, e.g.*, Niedermeyer v. Commissioner. 62 T.C. 280, 285 (1974), *aff'd per curiam*, 535 F.2d 500 (9th Cir.), *cert. denied*, 429 U.S. 1000 (1976); Fehrs Fin. Co. v. Commissioner, 58 T.C. 174, 187 (1972), *aff'd*, 487 F.2d 184 (8th Cir. 1973), *cert. denied*, 416 U.S. 938 (1974).

68. 58 T.C. at 185.

69. The court noted that the Supreme Court in *Davis* had concluded that Congress had a very limited purpose in reinstating the dividend equivalency test in the 1954 Code; the test "was included to ease what would otherwise be the harsh result of section 302 'in the case of redemptions of preferred stock which might be called by the corporation without the shareholder having any control over when the redemption may take place.'" 58 T.C. at 186 (quoting S. REP. No. 1622, 83d Cong., 2d Sess. 44 (1954)). In the instant case, Mr. Fehrs was not an unwilling participant in the redemption. On the contrary, by virtue of his retained 88.69% constructive ownership, he was the "guiding force behind it." *Id.* at 186. Such a characterization, however, would be applicable to any shareholder who controlled a simple majority. Thus, the court implicitly found that the Senate's definition of control would be inconsistent with any definition other than simple majority stock ownership.

For other cases discussing this Senate report, see *Davis*, 397 U.S. at 310; Benjamin v. Commissioner, 66 T.C. 1084, (1976), *aff'd*, 592 F.2d 1259 (5th Cir. 1979); Grey v. Commis-

The Tax Court iterated this position in *Niedermeyer v. Commissioner.*[70] Like *Fehrs Finance Co.*, this case involved a section 304(a)(1) redemption. As a result of Lents Industries, Inc.'s redemption of the taxpayer's voting stock in American Timber & Trading Co. (AT&T), the taxpayer's holdings of voting stock were reduced from a 90.49% actual and constructive ownership interest to a constructive 82.96% interest.[71] As in *Fehrs Finance Co.*, the taxpayer rested his claim to sale or exchange treatment on his complete abrogation of any direct interest in AT&T, coupled with his net reduction in ownership of 7.53%.

Rejecting the taxpayer's claim, the Tax Court made two observations. First, citing *Fehrs*, the court refused to recognize any distinction between actual and constructive stock ownership under section 302(b)(1).[72] Second, the court noted that the reduction was not meaningful: "With such a small change in a high percentage interest, [the taxpayer's] control and ownership of AT&T is essentially unaltered and cannot be considered to have undergone a meaningful reduction. An 82.96% interest clearly is sufficient to dominate and control the policies of the corporation."[73] As in *Fehrs*, there is nothing in the *Niedermeyer* opinion which indicates that the court defined control as other than simple majority voting ownership.[74]

The decision in *Furr v. Commissioner*[75] is the final case in the trilogy of Category II cases. *Furr* involved a redemption of 1.7% of the taxpayer's class B nonvoting stock. As a result, the taxpayer's percentage ownership of class B shares fell from 41.2% to 39.5%. The taxpayer's 72.34% interest in class A voting stock, however, remained unaltered. In reaching the conclusion that the taxpayer's

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sioner, 56 T.C. 1032, 1072 (1971), *rev'd*, 561 F.2d 753 (9th Cir. 1977); Lammerts v. Commissioner, 54 T.C. 420, 443 n.35 (1970). *See also* Postlewaite & Finneran, *supra* note 19, at 568.

70. 62 T.C. 280 (1974), *aff'd per curiam*, 535 F.2d 500 (9th Cir.), *cert. denied*, 429 U.S. 1000 (1976).

71. *Id.* at 287.

72. *Id.*

73. *Id.* at 287-88.

74. It is noteworthy that in support of its conclusion, the court in *Niedermeyer* relied on Stanley F. Grabowski Trust *ex rel.* Grabowski v. Commissioner, 58 T.C. 650 (1972). In *Grabowski*, the redeemed shareholder's voting interest remained unchanged; both before and after the redemption the taxpayer owned an 80.2% constructive voting interest. The court stated: "The 80.2 percent constructive interest herein is one which dominates and controls the policies of the company. This measure of control is sufficient to determine the payment of dividends and to cause the redemption of stock. . . ." *Id.* at 659. Thus, implicit in *Niedermeyer's* definition of control is an adoption of the simple majority stock ownership test for determining the existence of control.

75. 34 T.C.M. (CCH) 426 (1975). *See also* Furr v. Commissioner, 34 T.C.M. (CCH) 433 (1975) (related case).

reduction in interest was not meaningful as defined in *Davis*, the court focused on the issue of voting control.

The court observed that it had held reductions in interests much greater than 1.7% not to be meaningful where the shareholder was not deprived of his ability to control corporate activities.[76] In the instant case, the court found no such deprivation, since the taxpayer's voting control remained unchanged.[77] The court also concluded that absent compliance with the test established in *Himmel v. Commissioner*,[78] which includes voting right changes as one of three factors to be examined in determining dividend equivalence,[79] the minimum conditions of *Davis* were not met. Since the taxpayer had retained day-to-day control, the issue of the subjective "meaningfulness" of the distribution was never reached.[80]

The analysis presented in the *Fehrs-Niedmeyer-Furr* trilogy supports the conclusion that the retained-control test is the proper

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76. 34 T.C.M. (CCH) at 431; *e.g.*, Fehrs Fin. Co. v. Commissioner, 58 T.C. 174 (1972), *aff'd* 487 F.2d 184 (8th Cir. 1973), *cert. denied*, 416 U.S. 938 (1974).

Conversely, a few rulings have held reductions in voting ownership smaller than those in *Fehrs* and *Niedermeyer* to be essentially equivalent to a dividend. *E.g.*, Rev. Rul. 76-385, 1976-2 C.B. 92 (reduction from .000118% to .0001081% qualifies under § 302(b)(1)); Rev. Rul. 75-502, 1975-2 C.B. 111 (reduction from 57% to 50% meaningful because of potential deadlock). *See also* Private Letter Ruling 7827067 (reduction from 56.11% to 49.95% not essentially equivalent to a dividend).

Perhaps the most noted example of such a redemption appears in Rev. Rul. 76-364, 1976-2 C.B. 91. The ruling involved a corporation owned by four shareholders. The redeemed shareholder owned 27% of the voting stock prior to the redemption. The remaining 73% was owned equally by the remaining three shareholders. Thus, the taxpayer could exercise majority control by acting in concert with only one other shareholder. After the redemption, however, his interest was reduced to 22.27%. The Service ruled that the taxpayer had suffered a meaningful reduction in his interest because he had to enlist the support of two other shareholders to exercise majority control. *See also* Private Letter Ruling 7821145 (reduction from 29.33% to 24.33% not essentially equivalent to a dividend); Private Letter Ruling 7814032 (reduction from 34.89% to 30.48%).

Revenue Ruling 76-364 has been described as probably the most outstanding example of the control standard. Postlewaite & Finneran, *supra* note 19, at 584. The authors argue that "[t]he critical factor in the Service's opinion appears to have been a control element not representing dominance or a majority but rather a minority block's annoyance or veto power." *Id.* at 584.

The common thread running through these rulings is that after the redemption, the redeemed shareholder owned 50% or less of the voting power. It is only after reaching this conclusion that Rev. Ruls. 76-385 and 76-364 delved into the more difficult issue of determining the meaningfulness of the reduction.

77. 34 T.C.M. (CCH) at 431.

78. 338 F.2d 815 (2d Cir. 1964).

79. For a discussion of the factors relevant in determining dividend equivalency, see note 20 *supra*.

80. Finding that the taxpayer had retained control, the court stated: "At what point a distribution . . . might cause such a change in 'the basic rights of ownership' . . . as to cause . . . a meaningful reduction . . . we need not decide." 34 T.C.M. (CCH) at 432.

analytical tool for testing the dividend equivalency of redemptions from majority shareholders in transactions which fail to reduce the shareholder's voting ownership to 50% or less. Unlike the *Benjamin* type of redemption,[81] Category II cases involve actual reductions in voting stock ownership. Application of the relinquished-control test of *Wright* and *Rickey* in this category would force a court into the difficult position of rendering a subjective evaluation of the meaningfulness of a simple mathematical reduction in stock ownership on a case-by-case basis. Absent a loss of day-to-day control by the redeemed shareholder, the "retained-control" test eliminates the need for this subjective inquiry.[82]

C. *Category III: Simple Majority Control*

Category III redemptions involve cases in which the taxpayer actually or constructively owns more than half but less than two-thirds of the corporate voting stock before and after the redemption. Unfortunately, there is no case law dealing directly with such redemptions; Revenue Rulings 75-502[83] and 77-218[84] represent the primary authority in this area. It should be noted that the Service relied heavily upon these two rulings in Revenue Ruling 78-401.

Revenue Ruling 75-502 involved a redemption of stock from one of the three shareholders of *X* Corporation. Prior to the redemption, *A* owned three-sevenths of the voting stock of *X*, *B* owned three-sevenths, and an estate, of which *A* was the sole beneficiary, directly owned the remaining one-seventh. *X* redeemed the entire actual interest of the estate. As a result of the redemption, *A*'s interest rose to fifty percent which, by attribution, was constructively owned by the estate.[85] Thus, the estate and *B* became coequal owners of *X*. The estate claimed that the redemption was not essentially equivalent to a dividend and sought sale or exchange treatment under section 302(b)(1).

Using the tripartite analysis established in *Himmel*, the Service ruled in favor of the taxpayer. The pivotal factor in the ruling was the lack of day-to-day control by the estate over the affairs of *X*. As a result of the reduction of the interest of the estate to a constructive 50% block of voting shares, the only other unrelated shareholder's

81. Category I redemptions. *See* notes 57-64 and accompanying text *supra*.

82. *See* notes 41 & 47 *supra*. *See also* Rev. Rul. 73-2, 1973-2 C.B. 171 (100% before and 81% after equivalent to a dividend); Rev. Rul. 72-569, 1972-2 C.B. 203 (100% before and 85% after equivalent to a dividend).

83. 1975-2 C.B. 111.

84. 1977-1 C.B. 81.

85. *See* I.R.C. § 318(a)(3)(A).

voting interest was increased to 50%. In effect, the redemption had created the potential for a deadlock, so that the estate could not unilaterally exercise control over the day-to-day affairs of *X*. To help explain its position, the Service alluded to the impact that a reduction of less than 7% would have produced in this instance.

> If the stock of *X* held by the estate was reduced by less than 7 percentage points, the redemption would not qualify under section 302(b)(1) because the estate would continue to have dominant voting rights in *X* by virtue of its ownership of more than 50 percent of the *X* stock.[86]

The analysis in Revenue Ruling 75-502 received added support in Revenue Ruling 77-218, which involved a section 304(a)(1) redemption. The taxpayer, a trust, actually and constructively owned 60% of *X* and 75% of *Y*. After *Y*'s purchase of the taxpayer's *X* shares, the taxpayers retained a constructive 55% interest in *X*. Thus, the taxpayer suffered a net reduction of only 5% in his voting interest. Significantly, the Service rested its rejection of the taxpayer's claim to sale or exchange treatment in part on the taxpayer's retained voting interest in excess of 50%.[87] Consequently, the taxpayer was treated as having received a section 301 distribution.[88]

IV. Conclusion

The foregoing analysis demonstrates two consistent patterns. First, regardless of the degree of control possessed by a majority shareholder prior to a redemption, the single most important factor in determining the applicability of section 302(b)(1) sale or exchange treatment is the retention or loss of control over day-to-day corporate activities.[89] Second, there appears to be no persuasive reason for defining control other than in terms of those powers inherent in simple majority voting stock ownership.[90]

86. 1975-2 C.B. at 112. Revenue Ruling 75-502 has been viewed as one of the strongest proponents of the retained-control test. *See* Postlewaite & Finneran, *supra* note 19, at 582 n. 108 (loss of technical control dispositive); Randall, *supra* note 19, at 260-61 (loss of control most relevant factor). *See also* Private Letter Ruling 7933006 (meaningful reduction requires loss of simple majority control).

87. 1977-1 C.B. at 82. The Service also listed two other grounds for its holding: (1) the remaining stock was owned by shareholders related to the trust, and (2) *A*, who manages *X* and *Y*, served as cotrustee of the trust. *Id.* For a brief discussion of Rev. Rul. 77-218, see Postlewaite & Finneran, *supra* note 19, at 584.

88. I.R.C. § 301.

89. *See* note 76 *supra*.

90. *See* note 47 *supra*.

It is extremely difficult to reconcile the *Wright* and *Rickey* analyses with these two precepts. Indeed, the courts have consistently refused to attach any significance to a reduction merely in the absolute number of shares owned by the redeemed shareholder. Instead, courts have focused their attention on the rights represented by the percentage ownership of these shares. In instances where the redeemed shareholder has retained ownership rights in the form of day-to-day control over corporate activities, the courts have consistently denied sale or exchange treatment to such shareholders, regardless of the extent by which the shareholder's preredemption interest exceeded simple majority status.

In *Benjamin v. Commissioner,*[91] the Tax Court explicitly stated that the attributes of control relevant in a section 302(b)(1) analysis are the powers to determine the amount and timing of dividends and redemptions, appoint officers and set their salaries, control the board of directors, adopt a plan of liquidation, and authorize loans. The majority shareholder in Revenue Ruling 78-401 retained most if not all of these powers. The aspect of control actually relinquished conferred no affirmative power on the minority shareholders. Rather, the minority received only a veto power over those corporate activities which, by definition, were unrelated to the day-to-day activities of the corporation.[92] Viewed in this light, the relinquished-control test of the *Wright* and *Rickey* decisions has little to support it in case law, and less to commend it.

In sum, the retained-control test of Revenue Ruling 78-401 appears to be the better-reasoned analysis. This interpretation of the *Davis* meaningful reduction test derives great support simply from the fact that no post-*Davis* decision other than *Wright* or *Rickey* has afforded sale or exchange treatment to a redeemed majority shareholder who retains day-to-day control over corporate affairs. Moreover, the use of the retained-control test in factual settings typified by *Wright* eliminates one of the last areas of uncertainty still lingering in the section 302(b)(1) analytical framework. The loss of some degree of flexibility inherent in the relinquished control test of *Wright* and *Rickey* is certainly offset by the countervailing objectivity and predictability afforded by the retained-control test of Revenue Ruling 78-401.

91. 66 T.C. 1084, 1111 (1976), *aff'd,* 592 F.2d 1259 (5th Cir. 1979). *See also* Stanley F. Grabowski Trust *ex rel.* Grabowski v. Commissioner, 58 T.C. 650, 659 (1972) (control tantamount to ability to declare dividends and cause redemptions); notes 59, 64, 68 & 83-88 and accompanying text *supra.*

92. *See* notes 44-47 and accompanying text *supra.*